TRUSTS & ESTATES

ESTATE PLANNING & ADMINISTRATION

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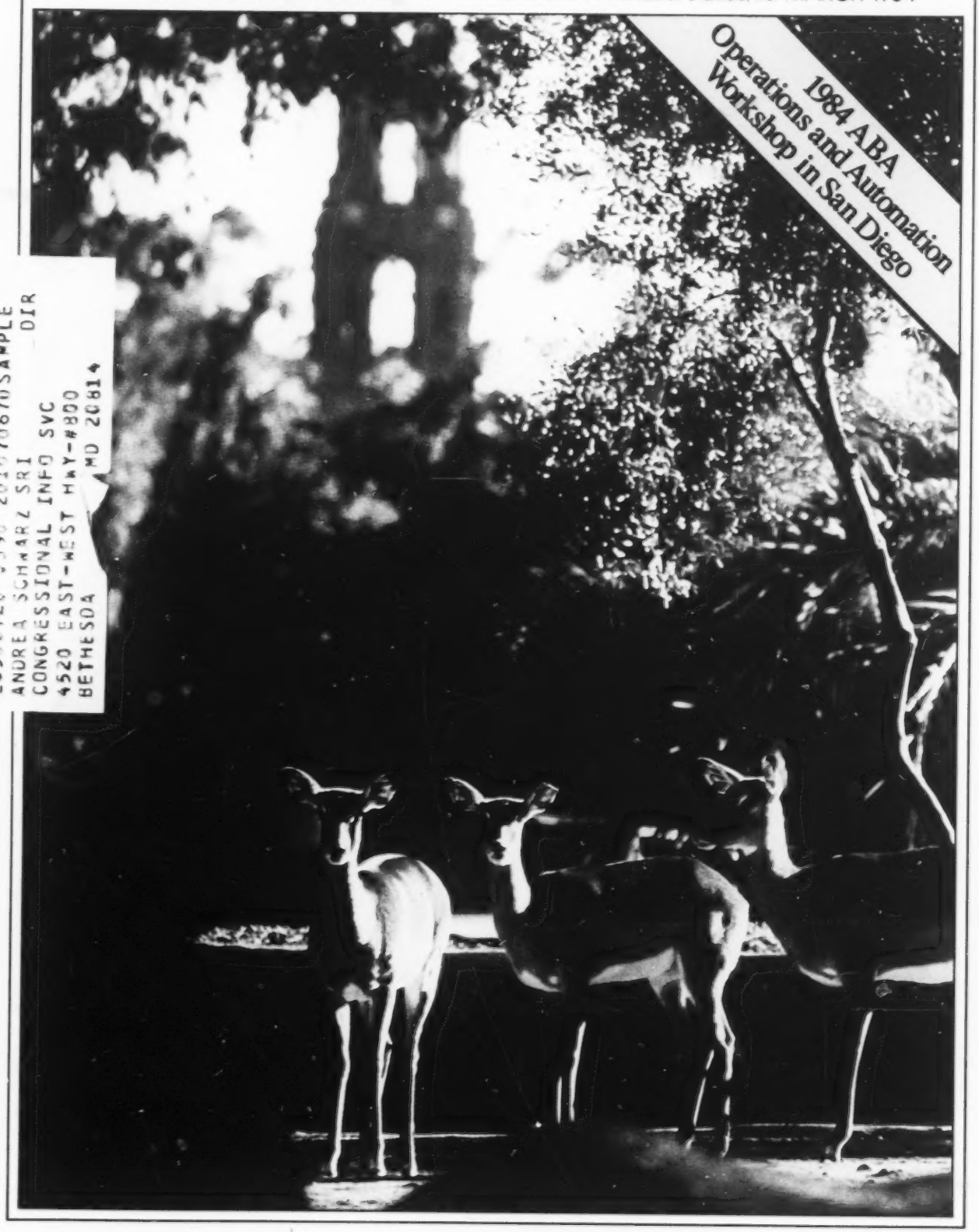

1984 ABA Operations and Automation Workshop in San Diego

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TRUSTS & ESTATES

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San Diego, which harbors rich wildlife resources in the form of its famous zoo, this month hosts the 1984 ABA Trust Operations and Automation Workshop. Cover photo of Kenyan impala courtesy of the San Diego Zoo.

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The Automation Practices Of Trust Departments — A Survey

Information is a barometer for how a trust department is doing

TRUSTS & ESTATES has participated with Fast-Tax, a computerized tax service based in Carrollton, Texas, in conducting the following survey of the automation practices of trust departments throughout the country. The purpose of the survey was to collect information that would reveal how trust tax departments operate, if they use micro-computers, and who in the departments decide what automated equipment/tax method should be used.

Two thousand three hundred questionnaires were mailed to trust departments drawn randomly from the 1983 Directory of Trust Institutions. Of these, 210 responses were recorded for a return of 9 percent, a respectable figure for this type of survey.

The survey should prove useful to trust tax personnel for comparative purposes. For instance, one question asked the respondents to indicate the number of 1041, 1040, 990, and 5500 returns their trust departments prepare. The question also asked whether they used a computerized tax service, in-house software, a trust system vendor, or manual operation to process or prepare the forms.

The responses follow in Chart I with a breakdown for departments with zero to fewer than 500 returns prepared, between 500 and 2,000 returns prepared, and for those with over 2,000 returns prepared.

"A department should be able to use this information as a barometer for how it is doing," says Bruce McCombs, marketing specialist with Fast-Tax. "The department may decide that it should automate if there is a sufficient volume of fiduciary returns."

The survey also includes information concerning the average number of returns prepared per tax specialist in banks with different work loads, which trust tax officers may find of interest for comparative purposes.

An unanticipated finding of the survey is that more people are involved in decision making in regard to what hardware and software is purchased. These people include CEOs, vice presidents, tax officers, operations officers, and other trust personnel, depending on the department.

And the survey shows that micro-computers are not an integral part of most trust tax departments, although there are exceptions. The majority of the departments rely on some form of automated equipment, however, including IBM 3033s, NCS, Burroughs, and Northern Telecom.

If technological trends continue spurred on by bank competition, McCombs says that increased automation is to be expected. The general consensus of the respondents was that trust tax departments will increase the number of fiduciary returns computerized, with 72 percent stating that there would be such an increase in their departments. □

Method Used	% 0<500	% 500<2000	% >2000	% Total 1041 Returns
Computerized Tax Svs.	36	37	34	35
In-House Software	3	9	46	27
Trust System Vendor	8	23	12	15
Total Computerized	47	69	92	77
Manual Preparation	54	31	9	22
Total	101*	100*	101*	99*

*Deviation from 100 percent due to rounding.

Automation Questionnaire

	1041 RETURNS 0 < 500	500 < 2000	> 2000	TOTAL
I. RESPONSE STATISTICS				
(1) #QUESTIONNAIRES RETURNED	143	46	21	210
(2) PERCENT (%) OF TOTAL	68	22	10	100
II. BANK PROFILE				
A. TITLE OF RESPONDENT:				
V.P.	59	23	10	92
ASSISTANT V.P.	7	7	4	17
TRUST OFFICER	59	4	3	66
TAX OFFICER	6	8	1	15
OTHER	10	3	3	16
TOTAL	141	45	21	206
B. CURRENT ASSET SIZE OF DEPARTMENT:				
0 < 50 M	87			87
50 M < 100 M	19			20
100 M < 500 M	23	19	1	43
500 M < 1B	3	12	2	17
1B < 5B	3	8	10	21
5B < 10B		4	5	9
10B < 20B		1		1
> 20B			2	2
TOTAL	135	44	20	200
C. NUMBER OF TRUST ACCOUNTS IN DEPARTMENT:				
PERSONAL	39243	60387	76650	176280
OTHER	28869	41071	23228	93168
TOTAL	68112	101458	99878	269448
D. NUMBER OF TRUST OFFICERS & FIDUCIARY RETURN PREPARERS:				
# TRUST OFFICERS	541	824	1019	2384
# TAX RETURN PREPARERS	164	144	163	471
TOTAL	705	968	1182	2855
E. TRUST ACCOUNTING SYSTEM: INTERNAL OR DO YOU RELY ON OUTSIDE VENDORS?				
BANKS	43	16	8	67
OUTSIDE VENDOR	97	29	13	139
TOTAL	140	45	21	206
III. AUTOMATED EQUIPMENT & TAX PREPARATION METHOD				
F. EQUIPMENT:				
APPLE	8	5		13
DECMATE	6	1		10
IBM PC	9	1	3	12
OSBORNE				
TEXAS INSTRUMENTS	2	5		7
TRS 80	3			3
OTHER	71	23	13	107
TOTAL	98	35	16	152
G1. # RETURNS PREPARED:				
1041				
COMPUTERIZED TAX SERVICE	6413	17934	24407	48754
IN-HOUSE SOFTWARE	448	4235	33061	37744
TRUST SYSTEM VENDOR	1404	11103	8750	21257
TOTAL COMPUTERIZED	8265	33272	66218	107755
MANUAL PREPARATION	9535	14728	6205	30468
TOTAL	17800	48000	72423	138223
1040				
COMPUTERIZED TAX SERVICE	1150	3378	6549	11077
IN-HOUSE SOFTWARE	46			46
TRUST SYSTEM VENDOR	5	603		608
TOTAL COMPUTERIZED	1201	3981	6549	11731
MANUAL PREPARATION	1577	1451	783	3811
TOTAL	2778	5432	7332	15542

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990				
COMPUTERIZED TAX SERVICE	59	49	509	617
IN-HOUSE SOFTWARE		250	144	394
TRUST SYSTEM VENDOR		5		5
TOTAL COMPUTERIZED	59	304	653	1016
MANUAL PREPARATION	284	888	1123	2295
GRAND TOTAL	343	1192	1776	3311
5500				
COMPUTERIZED TAX SERVICE	47	92	400	539
IN-HOUSE SOFTWARE				
TRUST SYSTEM VENDOR	151	455		606
TOTAL COMPUTERIZED	198	547	400	1145
MANUAL PREPARATION	1871	3060	916	5847
GRAND TOTAL	2069	3607	1316	6992
G2. INPUT METHOD:				
BATCH	14	10	8	32
TAS	15	16	6	37
TTI	13	9	6	28
TOTAL	42	35	20	97
H. COMPUTERIZED USAGE:				
INCREASE	79	34	14	127
REMAIN SAME	34	10	7	44
DECREASE	3	2		5
TOTAL	116	46	21	176
I. # CALENDAR & FISCAL RETURNS:				
CALENDAR:				
1041	16530	29726	43802	90058
1040	3198	5415	7077	15690
990	232	918	770	1920
5500	1257	1326	502	3085
TOTAL	19960	36059	51649	110753
FISCAL:				
1041	3943	18178	25798	47919
1040	193	20	35	248
990	281	422	699	1402
5500	1089	1651	514	3254
TOTAL	4417	18620	26532	52823
IV. DECISION MAKERS & ENHANCEMENTS				
WHO DECIDES ON PURCHASING COMPUTER?				
HARDWARE & SOFTWARE:				
DIRECTOR	9			9
CEO	28	8	4	38
PRESIDENT	45	4	2	51
EXEC. V.P.	19	10	6	35
SENIOR V.P.	29	17	9	55
		1		
ASST. V.P.				1
COMPTROLLER	4			4
PURCHASING OFFICER	4			4
OPERATIONS OFFICER	16	6	4	26
TRUST OFFICER	47	3		50
TAX OFFICER	4	4	1	9
OTHER	5	2	1	8
TOTAL	210	55	27	290
WHO DECIDES ON AUTOMATED MEANS (TO PROCESS RETURNS?)				
DIRECTOR	4			4
CEO	17	4	2	22
PRESIDENT	22	1	1	24
EXEC. V.P.	15	4	2	21
SENIOR V.P.	25	19	7	51
ASST. V.P.	1	1	2	4
COMPTROLLER	1			1
PURCHASING OFFICER	3			3
OPERATIONS OFFICER	7	7	3	17
TRUST OFFICER	58	6	2	66
TAX OFFICER	12	11	6	29
OTHER	3			3
TOTAL	168	53	25	245

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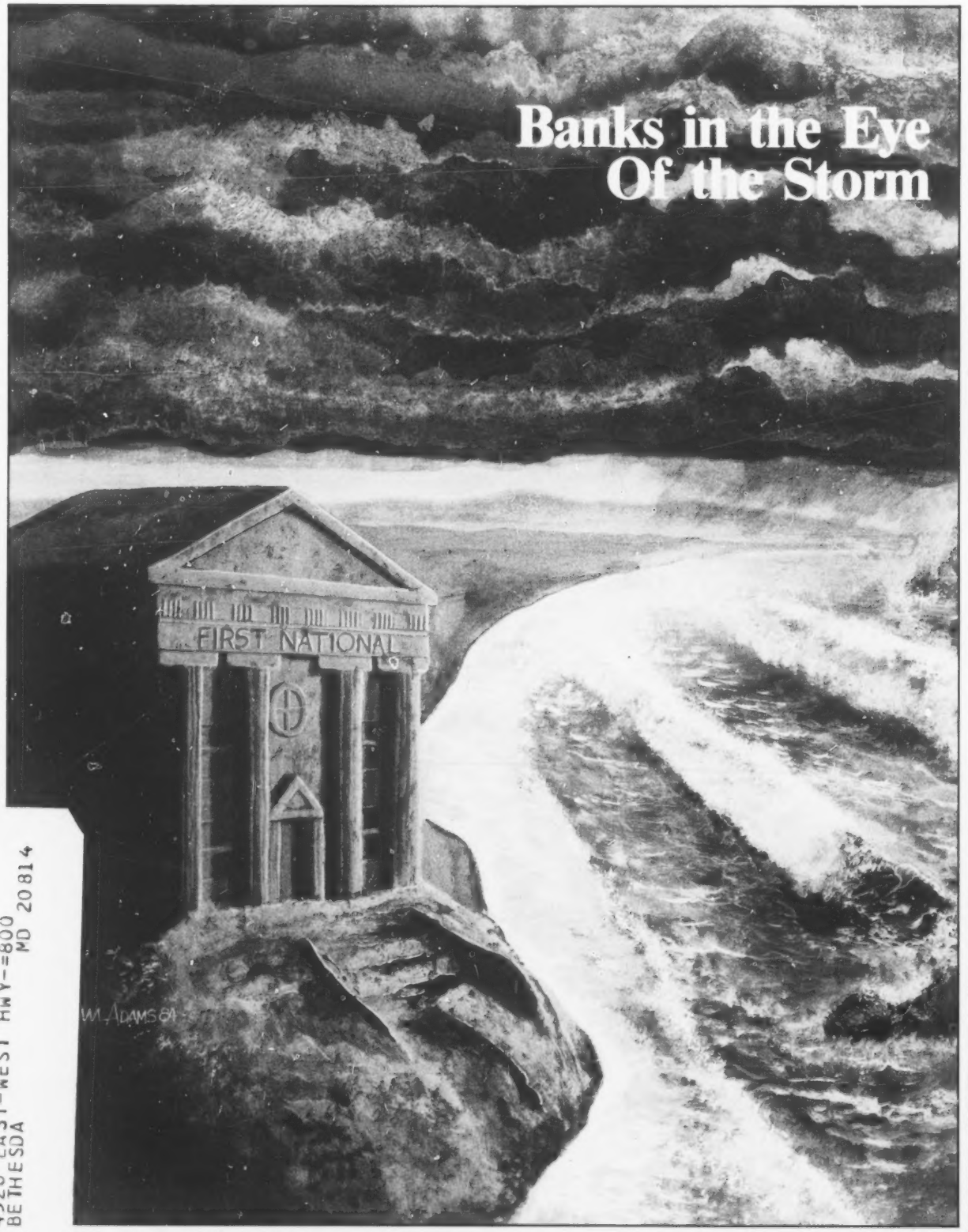

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TRUSTS & ESTATES

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COVER

The stormy winds and shifting sands of deregulatory changes have placed banks in a precarious spot. Martin McKerrow's update of bank vs. investment counselor performance adds to the concern; Samuel Hayes, Harvard professor of banking, discusses what lies ahead. Cover art by Bill Adams, asst. art director, CCI.

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Banks Lose Ground to Investment Counselors in '83

By **MARTIN MCKERROW**
Group Vice President
Financial Services Division
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New York, New York

In the May 1983 issue of TRUSTS & ESTATES, we examined equity results for bank and trust companies and investment counselors over the period 1973-1982. The story was a positive one for banks, as we showed that banks had turned the tide in 1981 and 1982 by achieving higher equity returns than investment counselors.

Results for 1983, however, are not as encouraging. While the three-year cumulative numbers do show bank superiority (Table 1), investment counselors held the edge in 1983 and over the past five years.

Perhaps more discouraging is the news that, despite increasingly competitive performance, the market share of banks has declined still further from that of 1982 (Chart I). Over the past 11 years, banks' market share has plummeted from 56 percent to 33 percent. In fact, in a recent and typical manager selection meeting, a sponsor was heard to specify, "Don't include any banks."

Chart I

1982	1983	
50%	55%	Counselors
37%	33%	Banks
13%	12%	Other*

*Includes insurance companies and self-administered funds.

Although last year's article focused on the reasons behind banks' equity superiority, it now seems more appropriate to examine the reasons — statistically — for banks' loss of market share. The non-statistical, organizational reasons have long been discussed, the statistical ones rarely. We have also included a brief analysis of successful bank organizations that might provide useful examples or role models for the industry.

The results discussed in this article are based on analysis of the 3,500 tax-exempt funds that make up SEI's Funds Evaluation Services data base. (Results for taxable funds will be available later this year from SEI's new Common Trust Fund Service.) Rather than look at equity only results, as we did last year, we have examined equity fund, or total equity portfolio, results. This study of the performance of "equity specialists" is particularly apt because the majority of investment manager searches involve equity managers.

Equity Fund Performance 1979-1983

A look at equity fund results is less encouraging than the equity only numbers (Table 2). The cumulative results for counselors exceed those for banks for all time periods. As we go back further in time, the gap widens.

Even more significant is an examination of the range of returns from the 10th to 90th percentiles over this time period (Table 3). Counselors have shown higher top end performance for all but the five-year period, and their range of returns is wider for one through four years.

In Table 4, the range of equity only results is shown. As we can see, banks as "equity specialists" have underperformed counselors at median for the last five years. In other words, as the role of the equity specialist has increased, the range of returns available from banks has narrowed in comparison with that offered by counselors. The curious thing about these results is that in 1979, when the popularity of the equity specialist was beginning to accelerate, the range of returns for banks was wider, but has since narrowed. The inescapable conclusion that can be drawn from these numbers is that banks present to the marketplace a narrower range of equity *disciplines*, or approaches, than counselors do.

This concept of a narrower range of disciplines is borne out when we examine the range of equity portfolio characteristics displayed by each type of manager. These characteristics provide an insight into the strategies used by banks and counselors.

In examining these portfolio characteristics, we can see that the range of measures is wider for counselors than for banks in all categories except market capitalization. In addition, this wider range has been maintained over the past two years. These portfolio characteristics bear out the conclusions suggested by the range of returns.

The median results for portfolio characteristics also point to a way to distinguish between counselors and banks. Banks tend to invest in stocks with lower betas, larger capitalization, lower price/earnings ratios, higher earnings growth rates, and higher dividend yields. That is, banks tend to be more conservative than counselors.

Another distinguishing characteristic is that counselors are more concentrated; they place bigger bets than banks. The SEIR measure, which indicates portfolio diversification, clearly illustrates that counselors were less diversified than banks across the investment spectrum. In a period when equity specialists were in favor, less diversification is a test of specialization that banks failed. Although "close indexing" is almost never seen, the higher level of diversification on the part of banks can nevertheless raise the accusation.

Manager Style

Another way to look at managers is on the basis of their equity "style." SEI has developed an approach for analyzing the impact of manager styles based on fundamental portfolio characteristics. (A specific description of each style is provided in the appendix.) Shown in Table 6 is the percent of managers in each "style" and the median return for each grouping for the year ending December 31, 1983.

Several observations can be made from this data. First, counselors have equaled or exceeded bank returns in all style categories. Second, banks seem to

be more conservative, i.e., more heavily oriented to the value and yield styles, than counselors. Third, banks have a higher percentage of funds that do not fit our characterization scheme; that is, more funds managed by banks fall into the "other" category. Fourth, a greater number of counselors are classified as undiversified, which means they are concentrated in a few industry groups or oriented to small capitalization stocks. Finally, more banks practice style rotation, and this has been the least successful style in terms of performance.

Another striking observation can be drawn from this analysis of manager style. Table 7 presents the percentage of managers in each style over the fourth quarter of 1983, the year 1983, rising market (July 1982-December 1983), and two years.

The strongest conclusion from Table 7 is the *stability* of style over time for counselors compared with the changes that occurred among banks. Over the past two years, banks have moved away from growth and sharply into value. In addition, a larger percentage of banks now show style rotation over this period, particularly during the rising market, which means that their chances for superior performance were lower. Only 6.7 percent of counselors do not fit into our categorizations ("Other"), compared with 12.3 percent for banks. For the two-year period, 23.6 percent of banks have either changed style (style rotation) or fail to fit our classifications, compared with only 11.6 percent for counselors.

Thus, we can conclude that the key to success for counselors seems to have been stability of style (lack of change) and pronounced style.

Stability and Variety

Inevitably this analysis leads to the conclusion that much more than investment results or personnel changes have caused banks to lose market share. As we have shown, this loss can be attributed to the fact that:

- Banks invest in a narrower range of disciplines than counselors.
- Banks are less stable in their investment approach than counselors.

In short, counselors have made the manager selection process easier for their prospective clients by offering more variety in results and approaches, while displaying more stability.

There is a clear message here. The fund sponsor is interested in more than just performance. He is attempting to create a structure for a plan, a structure that allows future expectations to be established in the present. To create this structure, he needs a clear set of alternatives from which to choose; to establish expectations now, he requires continuity and stability. Counselors provide these characteristics to a greater extent than banks. If the sponsor wants risk, there's more of that available from counselors, too.

Our article last year pointed to changes occurring in bank investment departments and suggested that these changes were aiding the results we discussed. This year we are clearly presenting a more somber evaluation of the manager world. However, last year's conclusions still hold true. Banks are implementing changes, and at a more rapid pace. Hopefully, forethought on their part will lead to future success. A brief examination of three success stories shows how this can work.

Successful Bank Organizations

While last year's story made good reading and this year's is more sober, there is a lesson that can be learned. To test the lesson, we identified three "successful" bank organizations. By successful, we mean that they have gained significant new business and kept that business.

One bank is located in the East, one in the Southeast, and one in the West. One is a large national organization, one medium-sized, and one smaller. There are a series of similarities among these organizations and some dissimilarities.

All three investment organizations had staff and structures separate from the parent organization, varying types of incentive compensation, and base salary programs for investment and marketing personnel that were significantly above typical bank levels. All had a well-defined investment approach, and all managed both equity and fixed

TABLE 1
MEDIAN EQUITY RETURNS BY MANAGER TYPE

	5 YEARS (1979-83)	3 YEARS (1981-83)	1 YEAR (1983)
Bank & Trust Companies	17.4	12.1	21.1
Investment Counselors	18.2	11.6	21.3

TABLE 2
MEDIAN EQUITY FUND RESULTS*

	Investment Counselors	Banks
5 Years	19.1	17.3
4 Years	18.3	17.2
3 Years	13.9	13.4
2 Years	21.8	21.7
1 Year	20.4	19.1

*For periods ending December 31, 1983.

TABLE 3
RANGE OF EQUITY FUND RETURNS

	Investment Counselors			Banks		
	10th	90th	Range	10th	90th	Range
5 Years	23.2	14.9	8.3	23.6	13.4	10.2
4 Years	22.6	13.5	9.1	22.6	13.1	8.5
3 Years	21.2	7.2	14.0	20.7	8.4	12.3
2 Years	29.2	13.8	15.4	28.0	15.2	12.8
1 Year	29.7	12.5	17.2	27.7	11.5	16.2

TABLE 4
RANGE OF EQUITY ONLY RETURNS

	Investment Counselors				Banks			
	10th	50th	90th	Range	10th	50th	90th	Range
1979	41.0	27.2	18.0	23.0	38.2	22.1	13.8	24.4
1980	51.8	37.5	20.3	31.5	50.1	32.2	23.6	26.4
1981	9.9	– 3.0	– 11.6	21.5	7.0	– 4.6	– 14.0	21.0
1982	33.9	23.8	10.2	23.7	34.1	23.6	14.6	19.5
1983	32.2	22.0	12.5	19.7	31.1	20.6	12.3	18.8

income investments, but did not specialize in balanced accounts. Their investment approach can be, and is, communicated in simple terms and is readily understood by prospective clients. All three can identify the value-added aspect of their approach.

The three organizations function on a team basis, with *all* personnel (including marketing) involved in investment decision making and the client communications process. All personnel also participate in client acquisition and retention strategies. They are strong and continual communicators. Their clients always know what's happening and why, even when the news is not good. To a large degree, the administrator is not the person who communicates with the client. The portfolio manager or marketing staff fills that role.

There are some dissimilarities. Two are bank subsidiaries, one for several years, the other for about a year; one is a bank investment department. Only one has no significant personnel turnover. One organization has only one equity discipline, another two, and the third several (although none marketed any of their products until they were ready).

Success came slowly for these organizations, only after much patience on their part and on the part of their parent organizations. They were all blessed with good performance, and all have maintained the continuity of their equity discipline. Perhaps most important, however, is their common commitment to excellence and success as well as their recognition of the importance of their client and that relationship. This, given their stability, may be the key to success.

Despite more competitive investment results over the past few years, banks continue to lose market share. The reasons for this loss appear to be a less pronounced equity discipline and more frequent changes in discipline than exhibited by counselors. As a result, counselors have been better able to meet their clients' needs. This was particularly true in a period when fund sponsors sought equity specialists. It is important to remember, however, that the purpose of this article is to examine the factors that contributed to past performance. Although the equity specialist was successful over the last few years, we certainly cannot say that this is the only "good" strategy or that the equity specialist will continue to be successful in the future. □

TABLE 5
EQUITY PORTFOLIO CHARACTERISTICS BY MANAGER TYPE

	PRICE/EARNINGS RATIO			
10th	15.4	16.4	19.1	19.7
50th	11.6	12.3	13.2	14.1
90th	9.3	8.9	11.0	10.7
Range	6.1	7.5	8.1	9.0

TABLE 6
MANAGER STYLE BY MANAGER TYPE

	Banks		Investment Counselors	
	%	Return	%	Return
Demonstrated Growth	9.5	13.5	12.8	16.1
Expected Growth	15.4	19.3	20.7	20.0
Other	14.4	20.8	8.1	21.7
Value	15.9	19.8	11.3	19.8
Yield	21.9	25.0	20.0	27.2
Style Rotation	7.0	15.2	3.5	21.4
Undiversified	16.9	16.7	23.3	21.7

TABLE 7
BANKS VS. COUNSELORS: MANAGER STYLE

	4th Quarter		1983		Rising Market		2 Years	
	B	C	B	C	B	C	B	C
Demonstrated Growth	6.8	9.9	9.5	12.8	10.6	13.6	12.3	13.5
Expected Growth	15.0	20.1	15.4	20.7	16.2	22.9	18.5	21.1
Other	15.0	13.2	14.4	8.1	17.7	8.8	12.3	6.7
Value	22.8	12.7	15.9	11.3	9.1	10.5	7.6	9.3
Yield	20.9	20.3	21.9	20.0	19.7	21.1	20.5	21.1
Style Rotation	4.0	3.9	7.0	3.5	7.6	1.3	11.3	4.9
Undiversified	15.5	20.0	16.9	23.3	18.8	22.2	17.4	23.3

APPENDIX

Demonstrated Growth

The portfolio's price/earnings ratio, return on net worth, three-year earnings growth rate, and market/book ratio must be in the top 50 percent of funds in the SEI equity universe. The P/E of the equity portfolios in the grouping indicates that investors expect their future earnings growth to be above the average of other pension portfolios.

Expected Growth

The portfolio's P/E ranks in the top 40 percent of the equity universe, but the portfolio does not have historical above-median patterns as measured by three-year earnings growth rate, return on net worth, and market/book ratio.

Other

These portfolios have no consistent strong P/E bias. This grouping consists of equity portfolios that have not consistently displayed the distinguishing characteristics of any of the other classifications.

Value

The P/E of the portfolio ranks in the bottom 40 percent of the equity universe. The expected earnings of these portfolios are not fully reflected in their price.

Yield

The portfolio's dividend yield must be in the top fraction of the equity universe. These portfolios are also characterized by below-median P/E ratios.

Style Rotation

A portfolio that moves over time between either of the growth categories and yield/value is included in this grouping.

Undiversified

The portfolio's Standard Error of Independent Return (SEIR) is in the top fraction of the equity universe. These portfolios have returns that can vary considerably from the S&P 500 return. Portfolios in this grouping usually have few stocks, few industries, and/or low capitalization stocks.

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Home Mortgages Learn to Compete in the Capital Markets

By **LELAND C. BRENDSEL**
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A little more than a year ago, Freddie Mac launched something of a revolution in the mortgage-securities market: the Collateralized Mortgage Obligation. In designing and introducing the CMO, our objective was simple - - to widen the spectrum of investors in mortgage-related securities. Today, because of our CMO and other instruments like it, billions of dollars are flowing into mortgage finance that not long ago would have been invested elsewhere.

Consider, for a moment, that CMOs — including a $525 million Freddie Mac issue — constituted roughly one-third of the amount raised by all new corporate debt issues in the first three months of 1984. By any measure, that is an impressive record for a security that did not even exist a year earlier.

Until last year, most investors knew Freddie Mac largely through its Mortgage Participation Certificates (PCs), the nation's first conventional mortgage pass-through security. Since 1971, Freddie Mac has issued more than $67 billion in PCs; last year alone, more than $60 billion of those PCs were traded through Freddie Mac's fifteen-member group of securities dealers. The advantages of pass-through securities — competitive yields, safety, liquidity, and monthly cash flow — have made them sought-after investments.

The development of the CMO stemmed from a recognition that a new type of mortgage security could attract new investors to housing finance — in essence, that an innovation could reach beyond the traditional investor market for PCs. Freddie Mac's efforts focused on the concept of a fixed-rate mortgage security, divided into varying maturity classes, that would pay principal and interest semiannually — in short, a more bond-like instrument.

The typical mortgage, after all, is not a very manageable asset. Mortgagors can prepay their loans — or default on them — at any time, and they tend to prepay their loans more rapidly as interest rates decline and more slowly as interest rates increase. These factors traditionally have meant that investors in mortgages cannot know when, or in what amounts, their investments will be returned, and what yield they eventually will earn.

Until recently, mortgage-backed securities — because they pass through principal and interest to all investors monthly as principal is received from borrowers — reflected the uncertainties associated with the timing of mortgage principal payments: they had no call protection, generated an uncertain cash flow, and never held a fixed maturity. As a result, mortgage pass-through securities like the PC held limited appeal for some institutional investors.

The Freddie Mac CMO was designed to address these problems. It combines semiannual interest payments, a guaranteed schedule of minimum principal payments, and a reasonable degree of call protection to certain classes of investors.

These concepts, of course, are not new. From 1975 to 1979, Freddie Mac successfully sold Guaranteed Mortgage Certificates, a single-maturity security that provided investors with semiannual interest payments and guaranteed annual principal-reduction payments. Freddie Mac discontinued its GMC issues, however, primarily because a downturn in the nation's economy decreased its relative strengths in relation to other mortgage-related securities, including PCs.

The GMC, nevertheless, laid the foundation for the CMO. We went back to the drawing board, with the help of First Boston and Salomon Brothers. We added a fast-pay/slow-pay feature, and designed a better method of guaranteeing that the bonds would return at least a specified semiannual payment of principal. These improvements, as the capital markets later demonstrated, were right on the mark.

Here, in short, is how the Freddie Mac CMO works:

Freddie Mac uses a single pool of mortgages to provide a payment stream that is allocated serially to several classes of securities. The result is a multi-tiered menu of maturities — each class with its own yield — from which investors may choose. All bondholders receive semiannual interest payments based on the coupon rate for their class. Principal payments on the underlying mortgage loans are combined, and paid first to holders of the shortest-maturity bonds. When that class is fully retired, all of the principal then is channeled to holders of the intermediate-maturity bonds. And so on.

Freddie Mac's first offering of CMOs sold out in a week, and it was not long before others — investment banking firms, homebuilders, mortgage bankers, insurance companies, thrifts, and other financial institutions — entered the market. By the end of 1983, eleven other issues of CMOs had been offered, for a total of nearly $4.7 billion. CMO activity this year also has been brisk. As of May 18, another eighteen issues of CMOs reached the market, bringing the total volume to more than $10.4 billion so far in 1984.

Since June 1983, these private issuers have followed Freddie Mac's lead: Pulte; Ryan Mortgage Acceptance; American Southwest Financial; Paine, Webber; Salomon Brothers; Norwest, Centex; Prudential; Kaufman & Broad; Lomas & Nettleton; Sears; and Travelers Insurance (with a $1.25 billion offering). As others follow, as they undoubtedly will, the market for CMOs will deepen and mature even more.

These private issues differ from the Freddie Mac CMO in one important re-

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spect. Because of Freddie Mac's financial strength, and its expertise in evaluating the mortgages it buys and projecting how they will be repaid, the corporation can guarantee investors a specified payment stream of principal. The CMOs offered by private-sector issuers, on the other hand, guarantee only scheduled amortization on the mortgages, even though they generally are marketed on an expected FHA repayment experience.

As we see it at Freddie Mac, CMOs have had four major effects on the market:

CMOs broaden the investor's base in mortgage securities. Through CMOs, Freddie Mac clearly has attracted new institutional investors to mortgage finance. In the first issue, for example, more than 60 percent of the second and third classes were purchased by pension funds and insurance companies seeking long-term assets to match their long-term obligations. In all Freddie Mac CMO issues to date, about one-half to two-thirds have been purchased by non-traditional investors in mortgage-related securities — pension funds, money managers, and bank trust departments.

CMOs give savings and loan institutions a powerful tool for restructuring their mortgage portfolios. By purchasing the early-maturity classes of CMOs, thrifts can match their traditionally short-term liabilities with short-term investments. Some savings and loans, in fact, are even considering using the CMO structure to issue their own securities; by using its mortgages to securitize a CMO with varying classes of maturities, a thrift could adjust its own portfolio by selling off certain classes and retaining others.

CMOs act as a catalyst for development of securities in the private market. While most CMO issues to date have been backed by Government National Mortgage Association securities (Ginnie Maes), the advent of private conventional CMOs is a hopeful sign. Because most homeowners have conventional mortgages, the market possibilities for conventional CMOs are greater than for Ginnie Mae CMOs. And because their underlying mortgages have higher yields than the FHA/VA loans underlying Ginnie Maes, conventional CMOs may offer higher yields than Ginnie Mae CMOs.

Norwest Mortgage, for example, believes that the potential market for conventional CMOs is so large that it has set up a separate financing subsidiary to handle such deals. Last February, Norwest Mortgage offered a $352.2 million conventional CMO issue through Salomon Brothers. American Southwest Financial also entered the conventional CMO market in February, with a $76.5 million issue backed by conventional mortgages, Freddie Mac PCs, and Fannie Mae CMBSs (Conventional Mortgage-Backed Securities).

CMOs reduce the cost of housing finance. Since the introduction of CMOs, spreads between mortgage-backed securities and Treasuries have been far narrower than their historic patterns. The decline in spreads has been caused, in part, by rising demand for the collateral for CMOs — mortgages and mortgage securities. And because CMOs offer a greater predictability of payments, investors have been willing to give up some of the higher yields they could earn on pass-through securities with no call protection. If mortgages can be resold at lower yields, they can be originated at lower yields, thus passing on the savings to homebuyers in the form of reduced mortgage rates.

The market has made it clear that investors like the CMO. From Freddie Mac's vantage point, several major factors account for the success of our four CMO issues to date:

Quality. CMOs are general obligations of Freddie Mac, a multibillion dollar financial institution with an unbroken record of profits.

Liquidity. In June 1983, the original CMO issue of $1 billion set a record as the largest single mortgage security offered for sale to the public. Three subsequent issues have pushed Freddie Mac's total CMO volume to more than $2.9 billion. The corporation expects to continue with additional offerings, further expanding the secondary market

Chart I
FREDDIE MAC
COLLATERALIZED MORTGAGE OBLIGATIONS
INVESTOR PROFILE

Series A — D

Investor Type	Percent of Total Dollars Invested
Thrift Institutions	11.1
Commercial Banks (Trust Departments)	26.9
Investment Advisers	18.3
Pension Funds	28.9
Insurance Companies	11.6
Other	3.2
Total	100.0

Based on 78.2% of dollars issued

for CMOs to new investors.

Guaranteed Maturities. Freddie Mac guarantees that the semiannual principal payments will be no less than the minimum specified in the offering circular. This assures that a maximum maturity date can be determined for each class of the CMO — a unique feature in mortgage-related securities.

If the mortgages pay down at a rate faster than the guaranteed schedule of principal payments, the additional principal will be paid to the CMO holders. On the other hand, if the mortgages pay down at a rate slower than the guaranteed schedule, the difference will be paid to bondholders from Freddie Mac's general funds.

Call Protection. Holders of the longer-term CMO classes receive a degree of call protection, because principal must be paid to holders of prior classes before their principal payments begin.

The CMO is a remarkably flexible instrument, and Freddie Mac has continued to search for ways to make it appeal to the broadest possible range of investors. As an example, our third and fourth CMO issues carried a new fourth class structured as an accrual bond, with interest accruing but not paid to investors until all prior classes have been retired. Principal and interest payments then are made according to a guaranteed payment schedule.

This fourth class was offered in minimum denominations of $1,000 (compared to $25,000 minimums for the first three classes), providing the first real opportunity for many individuals to invest in Freddie Mac mortgage securities. These bonds were positioned in the market as ideal investments for Individual Retirement Accounts (IRAs). As more and more individuals and securities dealers expand their understanding of the CMO as an investment instrument, small investors will show an even greater interest in this new security.

Chart II
CMO ISSUES
By Type of Issuer
(As of May 18, 1984)

Type of Issuer	Number of Issuers	Number of Issues	Amount
Freddie Mac	1	4	$2,933,675,000
Builder Bonds	4	12	1,848,033,000
Private Conduits	9	13	5,642,230,000
(1 Financial Corp.; 2 Insurance Co.; 3 Mortgage Banker; & 3 Dealer Sponsored)	14	29	$10,423,938,000

Source: Freddie Mac

Growth of Market

More than a decade ago, Freddie Mac's management envisioned that the mortgage investors of the future would include pension funds, bank trust departments, and life insurance companies — the institutional investors with the capital needed for the nation's housing industry. The corporation's first annual report, published in 1972, noted:

"The corporation is taking on the problem of the historically limited liquidity of mortgage investments, working in both the long and short term to solve that problem. The only real solution is in the long term — the creation of a truly liquid secondary mortgage market, similar to that which exists for corporate bonds."

In the time since, Freddie Mac has come a long way in meeting that challenge. The growth of the secondary market continues to be nothing short of phenomenal. As a source of funds for mortgages, sales of securitized mortgage pools have gone from zero in 1970 to more than $200 billion in 1982. Freddie Mac has been an important part of that growth, and its position in the market is impressive. Freddie Mac sold more than 70 percent of *all* conventional mortgage securities issued publicly from 1971 through September 1983.

In 1971, Freddie Mac created a market for pass-through securities in conventional mortgages. Today, that secondary market is vigorous and liquid. "With the explosive growth of mortgage-backed securities issues," *Moody's Bond Survey* recently noted, "liquid trading markets have also developed."

In 1983, Freddie Mac created a market for Collateralized Mortgage Obligations. As that market evolves, CMOs undoubtedly will be changed to reflect the needs of an even broader cross-section of investors. One reason Freddie Mac limited its first CMO to a three-class structure was the difficulty of explaining such an intricate instrument to investors. Today, those investors are better prepared to evaluate even more complex CMOs. Increasing the number of classes in a CMO decreases the yield required on each class; as a result, it's likely there will continue to be structural refinements in CMOs.

To date, most smaller institutions have been precluded from offering CMOs because the minimum volume for an issue is at least $100 million in each class. But with the growing popularity of "conduiting" — aggregating the mortgages of individual institutions under the umbrella of a single CMO — the universe of market participants is likely to expand significantly.

The development of the CMO has encouraged many portfolio lenders to rethink a perennial problem: how to limit risk by more accurately matching assets against liabilities. It has fostered a better climate in which private-sector firms can issue their own mortgage-backed securities, thereby contributing to the continued growth and stability of the secondary market. It has compelled a closer look at the concept of Trusts for Investments in Mortgages (TIMs), which could bring a host of new participants into the market. And the CMO, by focusing unprecedented attention on the mortgage-securities market in general, has forced a fundamental and long-overdue re-evaluation of the mortgage as an investment instrument.

Perhaps most important, however, this re-evaluation has triggered what appears to be a permanent repricing of mortgage securities, which today is effectively reducing the cost of American housing. From a long-range perspective, that represents an important step toward the ultimate integration of the mortgage markets with the capital markets. At Freddie Mac, that has always been our objective. □

Leland C. Brendsel was named executive vice president and chief financial officer for the Federal Home Loan Mortgage Corporation (Freddie Mac) in August 1982. He directs the corporation's finance and accounting functions, financial planning and analysis, and securities marketing.